SPARX Japan Fund

Fact sheet as at 31 December 2024

Fund description

The objective of the Fund is to provide long-term capital growth by identifying and acquiring undervalued Japanese equities by capitalizing on the Investment Manager's intensive in-house research expertise and extensive information network established through independent investment experience in Japan since 1989. The Fund will normally invest at least 80% of its assets in equity securities of Japanese companies.

Fund facts

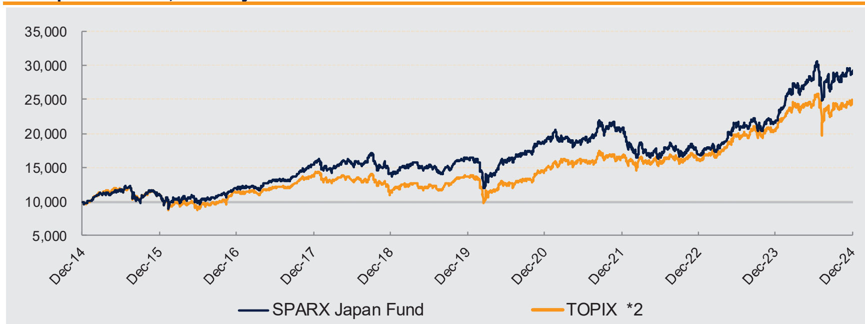
Portfolio manager	Masakazu Takeda
Portfolio manager since	November 2006
Strategy AUM ($ million)*, *6	5,492.92
Fund AUM (Net, $ million)*, *8	1,090.07
Fund inception	31 October 2003
Investment advisor	SPARX Asset Management
Fund domicile	Ireland
Legal structure	PLC

Regulatory structure	UCITS
SFDR classification*14	Article 8
Dealing frequency	Daily
Dealing cut-off time	17:00 (Ireland)
Administrator	State Street Fund Services (Ireland) Limited
Share classes available	JPY, GBP, USD, EUR, CHF
Investment style	All Cap, Quality Growth
Reference index	TOPIX (Total Return)

** Exchange rate USD/JPY= 157.160, W/M Reuters Close. Strategy size is based on internal estimates.*

Fund performance, last 10 years*1

30/12/2014=10,000



Fund performance (%)*8

Cumulative	Fund*1	TOPIX*2
Month-to-date	2.22	4.02
3 months	5.80	5.43
Year-to-date	33.57	20.45
Since inception	388.87	306.40

Discrete	Fund*1	TOPIX*2
2023	29.75	28.26
2022	-17.74	-2.45
2021	8.21	12.74
2020	16.98	7.39
2019	14.99	18.12

Top 10 holdings (% of NAV)*3,6

ORIX CORPORATION	9.76
Seven & i Holdings Co., Ltd.	9.21
Hitachi, Ltd.	7.57
Recruit Holdings Co.,Ltd.	7.38
SONY GROUP CORPORATION	5.66
Mitsubishi UFJ Financial Group,Inc.	4.71
Tokio Marine Holdings, Inc.	4.65
Sompo Holdings, Inc.	4.15
Shin-Etsu Chemical Co.,Ltd.	4.05
MS&AD Insurance Group Holdings, Inc.	3.84
Total	**60.98**

GICS Sector weight (% of NAV) *3,6,11

Financials	29.76
Industrials	20.93
Consumer Staples	11.71
Consumer Discretionary	11.25
Information Technology	10.42
Materials	5.40
Health Care	2.01
Communication Services	1.92
Real Estate	0.96
-	-
Total	**94.35**

Fund characteristics*3,6

Active share (%)*2,10	73.07
Active risk (%)*2,5	4.58
Annualized turnover (%)	20.56
Number of holdings	30
Yield (%)	1.99

ESG & Climate change*13	Fund*1	TOPIX*2
ESG Risk Score	20.28	23.06
Carbon Intensity (C/R) Scope 1+2	43.42	82.38
Carbon Intensity (C/R) Scope 3	80.16	119.97

Performance statistics*1,2,6,7

	Fund	TOPIX
Alpha (%)	-0.10	-
Beta	1.01	-
Standard deviation (%)	15.39	13.60
Sharpe ratio (Rf = 0%)	0.81	0.94

Market cap breakdown (% of NAV) *3,6

Large cap (top 70%)*4	86.93
Mid cap (bottom 15-30%)*4	7.42
Small cap (bottom 15%)*4	0.00
Other*4	0.00
Cash	5.65
Total	**100.00**

Share classes*9

Class		ISIN	AMC	Min investment	Acc/Inc
JPY	A	IE0067168280	1.50%	¥10,000,000	Acc
	C	IE00BNGY0956	0.90%	¥100,000,000	Acc
	E	IE00BF29SZ08	0.75%	¥5,000,000,000	Acc
	G	IE00BD6HM324	0.65%	¥20,000,000,000	Acc
USD	A*15	IE00BNCB6475	1.50%	$100,000	Acc
	C*15	IE00BNCB6699	0.90%	$1,000,000	Acc
EUR	C	IE000JEGIGP6	0.90%	€ 1,000,000	Acc
	C*15	IE00BNCB6368	0.90%	€ 1,000,000	Acc
	E	IE00BMDKDC31	0.75%	€ 35,000,000	Acc
	F*15	IE00BZ7MN936	0.75%	€ 35,000,000	Inc *12
GBP	C	IE00BYVLF156	0.90%	£1,000,000	Acc
	C*15	IE00BD4F5K64	0.90%	£1,000,000	Acc
	D	IE00BGPFC725	0.90%	£1,000,000	Inc *12
	E	IE00BJDQWX40	0.75%	£30,000,000	Acc
	E*15	IE00BNC0LD80	0.75%	£30,000,000	Acc
	F	IE00BK749L82	0.75%	£30,000,000	Inc *12
	F*15	IE00BNC0LF05	0.75%	£30,000,000	Inc *12

**1: JPY Institutional A Class Shares. The performance shown is net of fees. Inception date is October 31, 2003.*
**2: TOPIX Total Return Index is used as the Reference Index.*
**3: The figures are calculated in Japanese Yen.*
**4: SPARX defines market size as follows: Small-Cap is defined as the bottom 15% of the total market cap of the Japanese Market, Mid-Cap is defined as the next 15% of the total market cap and Large-Cap is defined as the top 70% of the total market cap. Other may include, but not limited to: ETFs, J-REITs and CBs .*
**5: The calculation excludes cash. Ex-ante tracking error. Annualized Standard deviation. Data source is Barra.*
**6: Source: SPARX Asset Management Co. Ltd. (Tokyo, Japan)*
**7: Annualized figures. Last 5-year period.*
**8: Source: State Street Fund Services (Ireland) Limited*
**9: Active share classes only.*
**10: Data source is Barra.*
**11: Sector data is based on MSCI's revised Global Industry Classification Standards. For more details, visit www.msci.com. Source: MSCI INC.*
**12: The latest dividend-paying share class distributions made on November 8, 2024 are as follows: GBP Hedged Class F Shares 0.4942 GBP per share ; GBP Institutional Class D Shares 0.3921 GBP per share; GBP Institutional Class F Shares 0.5254 GBP per share.*
**13: ESG Rating score corresponds to the Sustainalytics ESG Risk Exposure Category of the Fund. This exposure is defined by Sustainalytics and considers a company's sensitivity or vulnerability to ESG risks. Source: Sustainalytics. C/R is Carbon Emission to Revenue. Source: Trucost, in Tonnes CO2e/USD mn. These data providers may retroactively correct their data.*
**14: Sustainable Finance Disclosure Regulation ("SFDR") is part of the EU financial policy framework of regulatory measures aimed at providing consistent disclosure requirements in relation to sustainability.*
**15: : Hedged Shareclass*

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In December, the Fund returned 2.22% (net of fees; JPY Institutional A Class), underperforming its reference index, the TOPIX index with dividends, which returned 4.02%.

The month's positive performers among the Global Industry Classification Standard (GICS) sectors included shares of Industrials, Consumer Discretionary and Financials while Consumer Staples, Materials and Health Care detracted from the Fund's performance.

Among the best performers were my investments in SONY CORPORATION (6758), a diversified consumer and professional electronics, gaming, entertainment and financial services conglomerate, Recruit Holdings Co., Ltd. (6098), Japan's unique print & online media giant specializing in classified ads as well as providing HR services and Hitachi, Ltd. (6501), one of Japan's oldest electric equipment & heavy industrial machinery manufacturers.

As for the laggards, Seven & i Holdings Co., Ltd. (3382), a Japanese diversified retail group and operator of Seven-Eleven convenience stores, Shin-Etsu Chemical Co., Ltd. (4063), Japan's largest chemical company, and Nissan Chemical Corporation (4021), a manufacturer of liquid crystal alignment films and pesticide.

2024 Positive Contributors

Hitachi

The situation at Hitachi, which I introduced in detail as a new investment in the July 2021 letter, has been progressing largely as I anticipated. Since my first purchase in the first half of 2021, I quickly made it one of the largest holdings and the stock price has appreciated 216% since the end of December 2021.

July 2021 monthly commentary (https://bit.ly/3z2nBoU)

The Lumada business, which started in 2016, was initially perceived as a somewhat opaque business concept, even within the company itself. I view Lumada not as a business dependent on specific technologies or software, but as a "business brand" that generates revenue by proposing solutions that utilize all available resources within the company, shifting it from a traditional hardware sales model to one that includes everything from consulting, manufacturing, to after-sales service. The credit for developing this concept goes to the late President Nakanishi, who sadly passed away in 2021.

While the company has a wide business portfolio, it does not possess a dominant share in most product categories. However, being a conglomerate enables Hitachi to utilize its expertise in IT services, mission-critical social infrastructure operations, and manufacturing across various fields. The range of internal resources has expanded through the reorganization of the group over the past decade, which included acquisitions of new assets such as GlobalLogic, Hitachi Energy (formerly ABB) and Italian company Thales' ground transportation systems business. Another key point is that the business portfolio was re-oriented to cater towards growing business domains such as DX and GX.

In terms of financial strategy, Hitachi management's Key Performance Indicators (KPIs) have completely changed compared to a decade ago. They are now focusing on growth (Earning Per Share (EPS) growth), capital efficiency (Return on Invested Capital (ROIC), and cash flow (Free Cash Flow (FCF) conversion rate). I believe that this is a move in the right direction. In particular, ROIC has been increasingly adopted by many publicly listed Japanese companies in the last few years. Because Return on Equity (ROE) has shortcomings in that it can be influenced by the company's financial leverage strategy and tax system in the jurisdiction where it is domiciled, I also agree that ROIC and ROCE (Return on Capital Employed) are more appropriate as measures of a business's quality.

Turning to the results for H1 of FY24[1], adjusted EBITA[2] was 467.1 billion yen (up 16.5% YoY), and adjusted EBITA margin was 10.3% (up 2.2pts YoY), showing steady performance. The order backlog was very robust, with about 1.6 trillion yen in the Digital Systems & Services segment and a whopping 12 trillion yen at Green Energy & Mobility segment (Hitachi Energy 5.3 trillion yen, Railway Systems 5.9 trillion yen). The Lumada business is also expanding nicely, projected to account for 30% of total sales and over 40% of adjusted EBITA for FY24.

My current investment view

Regarding stock valuation, considering that the initial projected price/equity (p/e) ratio was 10.5x at the time of investment, the multiple has risen significantly over the past three years. Back then, even if the company's growth did not meet my expectations, its stock price was deemed reasonably valued as a manufacturing-centric conglomerate, with a p/e ratio that was sufficiently low, an ROE of over 10%, and a healthy financial position (with a high capital ratio of approx.30% and a debt-to-equity ratio of 0.54x). As a result, I considered it a sound investment with a high margin of safety. In contrast, today the company is widely recognized as an excellent enterprise in the stock market, and to some extent, has become institutional investors' favourite stock. As Hitachi already has all the "necessary pieces" in place for growth, the extent to which they can continue to accumulate new orders and how well they can convert the backlog into sales and profits will depend on the execution of the

[1] FY24 - Fiscal Year ending March 2025

[2] Adjusted EBITA (Earnings Before Interest, Taxes, and Amortization) is another management KPI where it is presented as adjusted operating income plus acquisition-related amortization and equity in earnings (losses) of affiliates.

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management team. In light of the significant re-rating, I believe it is necessary to exercise caution from here.

Mega-insurance groups (Tokio Marine Holdings, MS&AD, SOMPO Holdings)

Since June 2022, I have been invested in all three publicly listed Japanese insurance groups. While some may view the industry as mature and lacking excitement, I see it as an attractive business with opportunities, as outlined below.

Attractiveness of general insurance business compared to banks and asset management companies

As a business model, insurance companies receive premiums and in return, compensate for the cost of damages such as repairs in the event of a car accident or fire on behalf of the policyholder. The insurer earns profit by investing the premiums received until the insurance money is paid out. If no insurance claim occurs or the actual payout is less than the received premium, the insurer can pocket the difference. Thus, the main sources of revenue consist of investment income and underwriting income.

Insurance companies, banks, and asset management companies are all similar in that they generate revenue by utilizing external funds. But each one of these businesses has different characteristics. For instance, banks collect deposits and lend them out to earn "spread". Since the deposit belongs to the depositor, from the bank's perspective, it is "borrowing" from the outside. The interest paid to depositors is the bank's "fundraising cost". On the other hand, if the claim payment by an insurance company exceeds the received premium, the difference is effectively the "fundraising cost" (i.e. insurance underwriting loss). In the case of profitable insurance underwriting, the business incurs no fundraising cost, better yet the insurer gets "paid" to raise funds from policyholders. Therefore, an insurance company with a profitable underwriting business can be considered more attractive than banks.

Asset management companies receive funds from customers and earn management fees for their investment services. This is akin to a profitable insurance underwriting. However, unlike the insurance business where the returns gained from investing insurance premiums become the insurer's profits, the investment gains generated by an asset management company belong to the customers. This is another reason why the insurance business is more attractive. That is, an insurance company that can record a profit in underwriting and achieve high returns on investment qualifies as a great business.

Attractiveness of general insurance business compared to life insurance

What about the difference between general insurance and life insurance? One of the positive aspects of the life insurance business is the stable underwriting profits. This comes from the difference between the assumed mortality rate used in the premium calculation and the actual mortality rate, which fluctuates less than the occurrence of loss events in property & casualty insurance. Furthermore, life insurance contracts generally last for several decades, and the expected insurance payouts are fixed in the contract, so even in an inflationary environment, the burden on the insurance company does not increase (the insurer can pay off with depreciated dollars). In contrast, payouts by general insurance can go up with inflation in the form of rising automobile repair costs, etc.

A disadvantage of the life insurance business is when long-term interest rates are low, it typically does not enjoy high returns on capital. In this respect, general insurance companies are preferable because their contract periods are more short-term. They can expect their operating profits to improve at an early stage of rising interest rates. Furthermore, as will be mentioned below, general insurance can lower business risks through overseas expansion, which in turn should reduce equity risk premiums.

Overseas expansion by Japanese general insurers makes a lot of sense.

Today, Japanese banks, general insurers, and life insurers are all proactive in expanding overseas to increase scale. Among them, overseas expansion by general insurance makes the most sense due to the nature of its business, in my view. The domestic underwriting business of Japanese general insurers is dominated by automobile and fire insurance, and the risk of natural disasters is concentrated in typhoons and earthquakes. However, not all countries are like Japan. In particular, the U.S. is a huge market with a wide range of insurance fields. In addition to the mainstay auto and property insurance, other subsets of the industry like D&O insurance (directors and officers liability insurance), workers' compensation insurance, group health insurance, cyber insurance, and other special insurance markets are also well-established. Japanese general insurance companies can diversify their underwriting risks by entering these markets or through acquisitions. From an equity valuation perspective, this should theoretically lower equity risk premiums, translating into higher valuation multiples over time.

Japan's mega-banks are also focusing on the U.S. and Asia, but interest rate movements, which have a major impact on lending operations, tend to move in the same direction globally. For example, if interest rates rise in the U.S. due to rising inflation, it leads to a stronger dollar. This causes inflation in other countries through rising import prices, which puts upward pressure on their local interest rates. In other words, overseas expansion is not necessarily a good strategy when it comes to diversifying interest rate risks.

As for the life insurance business, insurance contracts are much more granular than non-life contracts with policyholders made up of a large number of individuals. For this reason, sufficient diversification is already achieved within its home market itself and expanding overseas does not contribute all that much to the diversification of the mortality risks.

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Unique competitive edge of Japanese general insurers

Next, I will explain why Japanese general insurers are uniquely positioned in the global insurance industry. As explained in my June 2022 letter, the competitive advantages of the Japanese general insurance industry are two-fold:

1. high profitability and abundant profits generated in the domestic market owing to its oligopolistic state, and;
2. the existence of "policy shareholdings" which have large unrealized gains.

Regarding the former, the domestic general insurance industry has consolidated after the so-called Japan's "Big Bang", financial system reforms in the 1990s. Today it is dominated by three insurance groups, namely Tokyo Marine Holdings, MS&AD Insurance Group Holdings, and SOMPO Holdings (with a total market share of approx90%). To my knowledge, there is no other insurance market in the world as concentrated as Japan. For example, in the US, over 50 companies operate in auto insurance alone as of 2020 with the largest company having only a 16% market share[3] making the competitive landscape far more intense.

On "policy shareholdings", the insurers purchased these shares (around 150-250 stocks of large public companies such as Toyota Motor, Shin-Etsu Chemical, ITOCHU Corp and many others) in the 1960s to build and maintain business relationships in corporate insurance, worth more than 6 trillion yen in aggregate market value as of the end of March 2024[4]. Despite the gigantic unrealized gains, these equity holdings have been viewed as "under-utilized assets" for a long time, leading them to liquidate in stages each year. This has been serving as a war chest for these companies, making it the other unique aspect of Japanese general insurers that cannot be observed elsewhere.

Japanese general insurers are good capital allocators

I believe that the management of all three listed insurance groups is excellent in the sense that they are practising exemplary capital allocation. In other words, each company is wisely using the abundant domestic profits as well as the proceeds from the sales of policy shareholdings in various ways to increase shareholder value.

One of these ways is overseas M&A. For example, Tokio Marine Holdings has been strengthening its overseas business for nearly 20 years. Particularly since 2008, the company has been actively acquiring businesses. As of the March 2024 fiscal year, around 46% of consolidated net insurance premium income and underwriting profit were generated by overseas operations.

When no strong M&A candidates are found, the insurers actively return profits to their shareholders. Particularly, in situations where the stock is undervalued, continuous share buybacks and dividend increases can be powerful tools. I like the fact that the management has the financial flexibility to improve ROE by suppressing unnecessary increases in shareholders' capital through these measures.

My current investment view

The Financial Services Agency of Japan (FSA) has requested that insurance companies accelerate the sale of policy shareholdings as part of their business improvement plans, with a submission deadline of February 2024. In response, each company expressed commitment to selling off all such shares over the next 6-7 years. The release was well-received by the market. As a result, stock prices have surged significantly in 2024. Consequently, this has narrowed the value gap that existed when I first invested in their shares.

Shifting my focus to the fundamentals, the difference in the insurance underwriting cycle, as well as the divergent trends in interest rates between Japan and overseas, suggests that the three major Japanese insurance groups are likely to perform steadily compared to their global peers in 2025.

The insurance underwriting cycle works as follows: When the underwriting business is in a favourable environment, the industry as a whole experiences stable pricing conditions, and the insurance loss ratios are low, resulting in good profits for all companies. However, as this state continues, competition among insurance companies intensifies, which leads to gradual declines in insurance premiums. Eventually, the industry's overall loss ratio starts to deteriorate, and profitability enters a downward cycle. When the industry-wide premiums research a certain level, underwriters, particularly the weaker players, begin to incur losses (combined ratios exceeding 100%), and price competition subsides. Once the underwriting cycle hits the bottom, it eventually turns upward (referred to as "hardening"). Historically, the cycle repeats every 5-10 years.

The current state of the global insurance market is worth noting, however. The US, the world's largest insurance market, is said to be in the late stages of an upcycle that began around 2018. Being in a prolonged period of hardening, the current cycle has been lasting longer than usual compared to past trends. As such, it is widely expected to enter a downward trend soon.

In Japan, meanwhile, insurers are expected to continue hiking premiums for auto and fire insurance policies from next year onwards. The increasing frequency of natural disasters due to abnormal weather patterns in Japan has led to chronic loss-making in fire insurance, while domestic inflation has pushed up auto insurance loss ratios since the economic reopening

[3] Source: National Association of Insurance Commissioners (2021) - The Top 10 Largest Auto Insurance Companies in 2022 | The Motley Fool)

[4] Source: YUHO Securities Report – March 2024

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following the COVID-19 pandemic. In response, insurance companies have announced plans for continued premium hikes, which are expected to improve their profitability outlook for the next several years.

Furthermore, interest hikes by the Bank of Japan are also expected. This will lead to an enhancement of investment returns for the non-life insurance business that primarily focuses on short-term fixed-income instruments. In contrast to the US, where the central bank's monetary policy is in an easing phase due to slower inflation and economic growth, Japan's monetary policy is moving in the opposite direction. As such, Japanese insurance groups may become favoured by the stock market again in 2025.

Recruit Holdings

Shares of Recruit Holdings, which I have been holding since 2016, have seen a significant surge this year soaring to all-time highs. Recruit is one of the "pure" growth stocks that I decided to keep during the major reshuffling of the portfolio back in 2022.

As a platformer, it operates various online media, with Indeed, the world's largest recruitment platform, at its core. Indeed, has been rapidly rolling out new services to enhance the efficiency and automation of corporate recruitment activities in recent years. As a result, the company's already formidable moats are being further strengthened.

Additionally, this type of internet platform business typically boasts high capital efficiency, high operating leverage, and high growth potential - a rare combination of three favourable factors. It is for this reason that high-growth internet companies often announce earnings that far exceed market expectations. As such, I consider the seemingly high stock price to be somewhat justified. I will discuss this name again in my upcoming commentary.

2024 Negative Contributors

Renesas Electronics

Renesas is a semiconductor manufacturer focused on microcontroller units (MCUs) and analogue semiconductors.
I consider the semiconductor sector to be an attractive industry within the broader manufacturing sector for the following reasons:

- The semiconductor industry provides high visibility for strong demand growth, driven by AI, autonomous vehicles, IoT, edge computing, 5G, and other applications.
- Advances in chip performance as well as production technology are also noteworthy, leading to frequent breakthroughs in semiconductor performance, density, and energy efficiency. These innovations drive up sales prices for the chips as well as manufacturing equipment, resulting in improved profitability for related stocks.

Renesas is one of the four semiconductor-related stocks held in my strategy, along with Shin-Etsu Chemical, Tokyo Electron, and Socionext. In the fall of 2022, the US-China semiconductor trade war escalated, causing sharp declines in semiconductor-related stocks worldwide. I took advantage of this timing to initiate investment in Tokyo Electron, followed by gradual purchases of other names.

Unlike Shin-Etsu (chip wafers) and Tokyo Electron (semi-cap), which are near monopolies/oligopolies in their respective fields, Renesas is one of many semiconductor manufacturers in a highly competitive market. Specifically, the company is a leading player in automotive microcontroller units (MCUs) and has been focusing on analogue semiconductors in recent years.

While my guiding principle has been to "invest in high-quality companies at reasonable valuations with strong management teams," I recognize that not all of my portfolio holdings align perfectly with these criteria at all times. Some companies excel in certain areas while presenting challenges in others, creating a diverse mix of strengths and weaknesses across my strategy’s investments.

In cases where a company align perfectly with these conditions, I usually prioritize "quality businesses" first. This means that even if a company's management team is not exceptional, I may still invest if the business itself is sufficiently attractive. That said, I also place a significant emphasis on "excellent management" in my investment decisions. In other words, if a company has an incredibly talented manager, it can become an attractive investment opportunity for me, even if the business's moats are not as compelling.

I believe that the investment appeal of Renesas lies in the management skills of President Shibata and the company’s attractive valuations. In 2013, Mr. Shibata, a former executive at the Innovation Network Corporation of Japan (also known as INCJ), joined Renesas as CFO and later took the reins as President in 2019. Under Mr. Shibata's leadership, the company addressed its vulnerabilities stemming from fluctuations in the semiconductor market, which previously led to significant losses during economic downturns.

Mr. Shibata’s efforts have transformed Renesas into a more resilient and sustainable business. Some of the key strategies he implemented include reorganizing its distributor network, which enabled better inventory control. Renesas also successfully bucked the industry trend by achieving legitimate price hikes. Furthermore, the reduction of in-house production by increasing the use of chip foundries resulted in lower fixed costs and flexible production adjustments.

Additionally, under Mr. Shibata's guidance, Renesas acquired and integrated several analogue semiconductor companies, including Intersil (2017), IDT (2019), and Dialog (2021) from the US and the UK, respectively. These acquisitions have enhanced the company's capability to provide customer-

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oriented semiconductor solutions, known as "winning combos."

Mr. Shibata's ability to rationalize the company while making bold investments without being constrained by past legacies is likely due to his experience in private equity investment and investment banking.

At the investor presentation held in September 2022, the company announced its "2030 ASPIRATION" plan, which includes an ambitious goal of increasing its market capitalization to six times its current value (as of Jan 2022) by 2030. To achieve this, the management team aims to double the business scale and triple the p/e ratio. The company has already made significant progress in stabilizing its earnings and building a resilient business model that can withstand economic downturns.
The company is aiming to rise to a leading position in the competitive semiconductor industry. To drive sales growth, it is focused on building differentiated services that provide semiconductor solutions. Key initiatives include the development of a "winning combo" by combining MCUs and analogue technologies, as well as the acquisition of Australia's Altium, a leading PCB design software company, to realize synergies.

My current investment view
The reason for the decline in stock price in 2024 is the delayed recovery of the semiconductor industry. The post-COVID-19 performance rebound has worn off, and the industry is now facing an inventory buildup issue.

Unlike at the commencement of my investment, I have come to assume a somewhat cautious view of the future of Renesas in recent quarters.

One factor is that EV sales are slowing down rapidly worldwide, and Japanese automakers, which are major customers of the company, are struggling to compete with Chinese rivals. This raises questions about whether the decline in automotive semiconductor sales is a temporary or structural issue. In particular, the rapid capacity expansion of Chinese companies in various industries (steel, solar panels, autos) has created supply pressure that exceeds domestic demand, leading to a surge in low-priced exports that are affecting competitors in other countries, including Japan. The Chinese government's strong financial support for domestic production is the likely root cause of the oversupply.

In the power IC field, local manufacturers' presence is increasing in China. In the medium to long term, there is a risk of intensifying competition in MCUs and analogue chips. These concerns may weigh on the company's stock valuations.

On the other hand, the valuation is inexpensive, with a p/e of 10x the forecasted profit for the next fiscal year (December 2025), which is significantly lower than the Japanese average. The EV/EBITDA ratio is slightly below 10x.

Major Trades
Seven & i Holdings
Since I began investing in July 2022, the strategy has consistently bucked the trend in the stock market, persistently (or stubbornly) accumulating its shares. As a proven retail format, the allure of the convenience store business is that it boasts high capital efficiency, robust cash flow, and largely resilient sales performance in times of economic fluctuations.

Despite having immense potential for overseas expansion including the U.S., the company's existing store sales have been sluggish in recent quarters, and its management has failed to optimize capital allocation. As a result, the stock price has unduly stagnated. However, the stock saw a significant turnaround in the latter half of 2024.

On August 19th, Seven & i released a press release stating that the company had received a merger proposal from Canada's Alimentation Couche-Tard, the global operator of the Circle K convenience store chain. The talks are still ongoing, and the outcome is yet unknown. The offer is currently being reviewed by the Special Committee of the Board of Directors, comprised solely of independent outside directors, set up internally within Seven & i.

According to various media sources, last year's acquisition offer is not the first time the company has been approached by Alimentation Couche-Tard; it had received similar proposals twice in the past, including in 2020. Allegedly, these proposals were rejected without being ever publicly disclosed, depriving existing shareholders of the opportunity to sell their shares at a higher price. This was a grave matter from shareholders' point of view as well as a significant missed opportunity.

In recent years, corporate governance reforms in Japan and pressure from activist investors like the U.S.'s ValueAct (they launched a shareholder campaign against Seven & i, escalating it to a proxy fight in 2023) have driven changes in the company's governance structure. Seven & i is no exception.

In May 2022, the company finally transitioned to a board composition with a majority of independent outside directors. The following year, in March 2023, an independent strategic committee was established "to objectively assess and monitor the group's key strategic initiatives and optimal group structure". This was a landmark event in the company's history, which had been rife with suboptimal capital allocation decisions.

Furthermore, in August 2023, the Ministry of Economy, Trade and Industry (METI) announced guidelines for corporate acquisitions. It is due to this that the company swiftly

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announced the acquisition offer this time to the public and transparently launched an evaluation process. As of this writing, the Special Committee is objectively considering all options (including the counterproposal that emerged from the Ito family, the founding family) to realize the company's potential value. The role played by ValueAct and the others in driving this transformative change in the company's governance cannot be overstated.

Seeing these developments, I too made an unusual move. After requesting direct communication with the company, I had the opportunity to have a one-on-one meeting with Stephen Hayes Dacus, the chairman of the Special Committee on September 18th, where I conveyed my expectations on what kind of outcome I would like to see as shareholders, and what needs to happen should they choose to reject these proposals. At present, it is unclear which proposal will materialize in the end. However, I believe that Couche-Tard's indication of interest in Seven & i has demonstrated the company's attractiveness to potential acquirers. As such, the merger proposal was extremely positive for the shareholders. Even if all acquisition negotiations fail, the possibility of new buyers emerging remains high, which should mitigate the downside risk of its stock price. Meanwhile, the potential upside on this investment should the company be run successfully remains compelling.

Orix

I initiated the position in Orix in the summer of 2022 and have continued to accumulate through 2024. As explained in my July 2024 commentary, Orix benefits from being "a hidden inbound tourism winner" and is also favourably positioned to capitalize on the normalization of domestic interest rates.

July 2024 monthly commentary (https://bit.ly/4cjuB3P)

In November, I held a direct meeting with the company's CEO (at the time of the meeting), Mr. Inoue, to discuss two key topics: 1) the company's mid-to-long-term growth strategy, and 2) its communication approach with the stock market.

Regarding the first topic, I zeroed in on the company's efforts to strengthen its asset management business, which was described as an "Asset Management Shift" in the company's 2Q FY24 earnings presentation (P48). Our conversations delved deeper into aspects that were not fully covered in the earnings presentation or annual report.

I brought up discussions around the following points:

a) How to raise permanent capital or long-term (and even ultra-long-term) capital for its Assets Under Management (AUM)
b) How to secure stable and profitable fee-related earnings (FRE).
c) Which asset classes to focus on?

In my view, strategies a) and b) are essential for a robust asset management business and achieving them relies on c).

While I will omit the details, my main takeaway is that the company is contemplating leveraging limited partnership structures as the main fundraising strategy. Notably, there was no mention of listing schemes for investment fund vehicles as a solution for permanent capital, similar to those undertaken by the likes of Brookfield Corporation (Canada) and Pershing Square (the U.S.), the expansion of investment capital through the use of life insurance arms (long-term annuity products), as exemplified by Apollo Global Management and KKR etc, or the float-based investing famously pioneered by Berkshire Hathaway. The differences in insurance regulations between overseas and domestic markets are hindering some of these approaches.

At this stage, the company seems to prioritize augmenting returns on individual investments by primarily using its funds (i.e. principal investments), rather than maximising the number of investment deals through a more scalable scheme. Therefore, it is likely that the company will continue to focus on realizing profits from the exiting of investments, which can be lumpy at times.

In terms of asset class, I expect demand for alternative investments to be the most promising. Therefore, as the industry is poised to experience significant growth in areas such as private equity, private credit, and infrastructure investments, Orix's future growth trajectory will be determined by which specific asset class(es) and region(s) to focus.

Since the 2008 Global Financial Crisis, Basel III and other regulatory tightening have led to a trend of European and American banks reducing their exposure to risk-weighted assets. This has opened up a new market for private credit players. On the demand side, the massive "transition finance" required to achieve decarbonization over the next several decades - estimated to be in the hundreds of billions of dollars, if not in the trillions - will drive demand for capital.

Furthermore, the proliferation of EVs and AI data centres will also require substantial funding for additions to power capacity. The shift towards domestic manufacturing in countries like the U.S. will lead to new infrastructure investments, rebuilding of logistics networks, and factory construction, all of which require enormous long-term funding.

These projects pose challenges for traditional banks, which rely on short-term funding in the form of deposits. Amid these gigantic social changes, Orix could capitalize on business opportunities through scalable asset management operations, and this potential is not to be underestimated.

SPARX Japan Fund

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Interestingly, the company has already demonstrated its expertise in operating airport facilities (Kansai International Airport) and renewable energy power plants (in Japan as well as through Spain's Elawan and India's Greenko, etc), well-experienced in investing in shipping and aircraft leasing assets (Orix is the third largest in the world, behind AerCap Holdings and SMBC Aviation Capital), residential/commercial real estate, and private equity. Although its international presence is relatively small, it has also expanded its strategies to include private credit, traditional asset management, and CTA (Commodity Trading Advisors), among others.

Notably, its asset management business, led by the European asset manager Robeco (acquired in 2013), has amassed a significant amount of AUM, reaching 69 trillion yen in aggregate as of the end of March 2024. The management's mid-term goal is to expand this further to 100 trillion yen ($660 billion).

I plan to continue the dialogue with the management team to have a better sense of the future strategic direction of the business.

Another topic I discussed was the market valuation of their stock today. Based on my observation, there appears to be a disconnect between management's assessment of their stock and the message they convey to the market. Furthermore, their communication sometimes lacks consistency.

At its earnings briefings, management often mentions ROE is the key metric for better share price performance. It wants to reach 10% and believes that it has been short of that target. I believe this approach is utterly wrong.

Firstly, the conventional ROE calculation formula uses the current period's net profit, which excludes "other comprehensive income," as the numerator, while the denominator includes total equity, which incorporates "other comprehensive income." This inconsistency between the numerator and denominator means that when "other comprehensive income" is high, the denominator increases, resulting in a lower ROE.

For an investment company like Orix, items such as" net unrealized gains (losses) on investment in securities" and " foreign currency translation adjustments" are crucial components of other comprehensive income, which are just as important as net profit when evaluating management performance. If I was to include comprehensive income in the numerator, the company's ROE for the fiscal year ended March 2024 would be 14.6%, and 12.4% for the fiscal year ended March 2023. This means that management is effectively meeting its self-imposed target of 10% ROE already.

Secondly, the company's sources of profits consist of three components:

a) The current year's net profit is reflected in the income statement.
b) Items reflected in other comprehensive income.
c) Unrealized gains that are not reflected in the balance sheet, even when the value of held assets increases during the fiscal year.

In other words, under the current accounting rules, the appreciation of held assets is not always recognized as the current year's profit, and some unrealized gains on held assets are not even reflected in the balance sheet. Therefore, I believe ROE does not accurately capture the company's true financial performance. On this point, I am completely at odds with some of the sell-side analysts who claim in their reports that Orix should not deserve a higher p/e as ROE continues to languish below 10%. This to me makes very little sense.

As I argued in the July 2024 commentary, the company's business model in its current form is that it invests in various operating businesses, operating assets as well as financial assets, then enhances their earnings and asset values to grow their intrinsic value, to realize profits upon exiting in the future. Thus, instead of focusing on future cash flow projections, I look at the increase or decrease in BPS (i.e. Net Asset Value (NAV)) and interpret it as the approximation of changes in the intrinsic value for the year[5].

The reason I say it is just the "approximation" is because Orix holds on its balance sheet a wide array of assets as explained above, whose unrealized gains have not yet been reflected. Additionally, in aircraft leasing, there are many aircraft on order for future delivery with large unrealized profits that are due to be put on the balance sheet at later dates. When valuing Orix shares, I consider the Price/Book Ratio ((PBR) based on the current market value of the assets (i.e. NAV)-based approach), which considers these sizable unrealized gains.

Interestingly, Mr. Inoue himself shares a similar view. Specifically, he recognizes that the annual growth rate of NAV should be the annual report card of management performance. His objective is to grow at 10% per annum over time. The way he values Orix shares is evident from his statement at an investor group meeting, where he mentioned that "a PBR of 1.5x would be equivalent to a PBR of 1x when

[5] Conversely, for manufacturers, improving shareholder value through the replacement of factories and production assets is not their modus operandi. Therefore, a valuation based on an increase in the value of owned assets is not appropriate.

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considering unrealized profits" (from a CEO interview memo by SMBC Nikko Securities on May 30, 2024). That's a 50% implied return, and they will be realized over time.

However, on other occasions, I often hear remarks from the management about ROE being a crucial metric for stock price performance especially during earnings calls. According to the CEO, the current market trend characterised by the Tokyo Stock Exchange's PBR 1x reforms suggests that ROE-based evaluations are most easily accepted/understood by the market. Contrary to this, I suggested they reconsider the use of ROE in investor communication going forward.

Meanwhile, market participants (buy-side and sell-side analysts alike) should also conduct stock valuation analysis more independently, rather than blindly accepting the numbers released by the company or conventional metrics. By doing so, I believe that there is significant room for improvement in Orix's stock.

Lastly, if the proportion of capital-light businesses through the company's "asset management shift" increases, it would enable the management to buy back its shares to further reduce equity without sacrificing its financial stability. This should make it easier to boost ROE, which in turn could lead to a higher p/e ratio. Consequently, a scenario where p/b substantially exceeds 1x also becomes plausible.

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Fact sheet as at 31 December 2024

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